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TAGS: PGOV PREL UNMIK KV ECON
SUBJECT: KOSOVO: KOSOVO ENERGY DEVELOPMENT AT CRITICAL JUNCTURE

Classified By: Ambassador Tina S. Kaidanow for Reasons 1.4 (b), (d).

¶1. (C) Summary: Kosovo's future rests on efficient development of its vast lignite coal reserves, which can propel investment and improved living standards for the next half century or more if properly exploited. After years of frustrating delay, Kosovo's government is ready to take the final steps towards tendering this immense development project, but differences between key international stakeholders -- specifically the World Bank and the U.S. Embassy -- on the question of how to provide interim power for Kosovo until such time as the "New Kosovo" energy plant comes online is hindering further progress.

¶2. (C) Summary, cont. This issue is a make-or-break one for Kosovo, whose citizens now suffer daily blackouts and where an increasingly frightening share of the government's budget is diverted into sustaining the two aged and decrepit electricity plants of the Kosovo Electric Company (KEK) that currently provide power. The budgetary outlays for KEK will spiral into the multiple hundreds of millions of euro beginning in 2010 if KEK privatization -- both the generation and distribution elements -- is not successfully completed this year. The key issue on which internationals disagree is whether to bundle the old generation plants into the tender for the "New Kosovo" plant; the World Bank opposes on the grounds that this could discourage bidders in a difficult global financial climate from investing at all, while the Embassy feels strongly that separating the two transactions will orphan the old generation plants and bleed the Kosovo budget dry. The political instability that could result from diverting a quarter or more of Kosovo's budget into energy generation (and dramatically reducing other elements of the budget, including public sector salaries) for the next five to ten years is a serious and sobering prospect. Embassy urges the Department to review the stakes involved with World Bank representatives and reach consensus on a way forward that preserves the interests of the Kosovo government and the USG. End summary.

The Current Situation

¶3. (SBU) Kosovo's electricity situation is dire. Two 1960s and 70s era plants, known as Kosovo A and B respectively, provide power to Kosovo's two million inhabitants. Due to age, condition, and lack of capacity, there is insufficient power to meet all of Kosovo's domestic needs, and Kosovo has imported on average 50-80 million euro worth of energy for the last several years. Regional power is scarce, making it likely that in future these costs could go up significantly. Power is distributed on a load-shedding basis, meaning that those who pay their bills consistently (by neighborhood) get

more electricity, while those who pay nothing (a significant share of the Albanian population and almost the entire Serb population of Kosovo) get a modicum of electricity throughout the day. On days when parts of the A and B plants are down for maintenance or repair, a frequent occurrence here, even the reliable bill-payers can be blacked out for hours at a time. The size of Kosovo's outlay to keep A and B running has risen steadily; capital expenditures for KEK are on the order of 80 million euro per year, and could explode if there were a systemic failure in either the A or B plant. To make matters worse, the existing lignite field that supplies A and B will run out of coal as early as 2010; a new mine must be developed immediately or disaster could ensue. The cost of opening the mine is roughly 400 million euro; the government has already allocated 160 million euro for this purpose, but if New Kosovo is not awarded this year (in which case the bidder assumes much of the exploitation costs), a further 130 million will be needed in 2010, 90 million in 2011, and 20 million in 2012.

¶4. (SBU) The great hope for Kosovo is the development of a new mine project and energy plant, formerly referred to as "Kosovo C" but renamed "New Kosovo" by the Thaci government. The new generation plant would dramatically alter Kosovo's energy position, making it possible not only to meet domestic needs but to export up to 800 million euro worth of electricity per year. The implication of this for Kosovo's economy is staggering; the macro department of the Ministry of Finance estimates that the GDP impact of the project would be as high as three to five percent in the first year, assuming that the winning bidder on New Kosovo also takes responsibility for the old A and B plants and brings them up to peak efficiency. Subsequent years of the project, even

before the new plant is fully online, could bring .5 to 1 percent of growth per year. Income from the New Kosovo deal is estimated to be in excess of 100 million euro per year, a substantial incentive for any bidder to meet Kosovo's terms.

The Big Disagreement: Interim Power

¶5. (C) There is general consensus among all stakeholders that time is now of the essence in concluding the final elements of this bidding package. Momentum and investor interest may wane after the multiple years that have been spent in developing the project, and other energy projects are being offered to interested bidders elsewhere in the region, including in Serbia. Key differences have emerged among stakeholders, however, on whether to include the privatization (or operation and management) of Kosovo A and B in the deal for New Kosovo -- i.e., whether to address the issue of interim power for Kosovo (in the period before New Kosovo is operational) through the medium of the New Kosovo project.

¶6. (C) The World Bank, which has taken the lead on the New Kosovo project and has paid for the transaction and legal advisers, opposes a "bundled" project for fear that in the current global financial climate, bidders will reject taking on the costs associated with bringing A and B up to speed. Using as evidence apparent (and troubling) contacts that Bank officials have had outside the scope of the transaction adviser's purview, they claim that several of the four large consortia which passed through the earlier Expression of Interest phase (and thus have been vetted for participation in the upcoming tender) have already indicated their lack of interest in a deal that would encompass both New Kosovo and the old generation plants. The Bank also argues that the necessary due diligence and feasibility studies on A and B would unduly delay the New Kosovo tender. They acknowledge the problems inherent in providing interim power for Kosovo, but believe that the budgetary and political risks are manageable, particularly if Kosovo improves KEK collections, eliminates the backlog of payment cases from the courts, and maintains upkeep on the existing plants. The Bank contends that privatization of A and B is a possibility, but insists on delinking such a prospect from the New Kosovo project or at least placing it on a "separate track."

¶7. (C) Our views are quite different and are based on extensive interaction over the last six years with both KEK management (via USAID's PA consulting contract) and the Ministries of Finance and Energy (where USAID's Bearing Point advisers have had ample exposure to the disturbing details of the Kosovo Consolidated Budget). By far the most concerning aspect of leaving A and B to be managed by Kosovo over the next years is the budgetary one. With imports, capital expenditures and costs associated with the new mine set to balloon well over 200 million euro in 2010 and beyond, we fear the tidal wave could simply overwhelm Kosovo's ability to cope. The IMF has made plain that this level of expenditure is simply not possible for Kosovo to sustain. Even deep cuts in other budget lines, including those for public salaries and other outlays, would not be enough to alleviate the drain. Improvements in KEK collections might offset these costs on the margin, but could not address the capital needs of the increasingly fragile A and B plants. Expenses for capital equipment purchased by the Kosovo government are also substantially higher than those that would be incurred by any of the private consortia, which enjoy economies of scale through their global reach.

¶8. (C) We would refute other elements of the Bank's assertions, as well. Specifically:

-- Contrary to the Bank's contention that bidders would reject bundling A and B with New Kosovo, the actual evidence seems to point in a different direction. The transaction adviser, which met one-on-one with each of the four consortia, has drafted a report for the New Kosovo Project Steering Committee (composed of representatives of the Kosovo government, with participation as observers by USAID and the World Bank) that paints a substantially more positive picture. One of the consortia did indicate it would prefer not to include A and B, but another was anxious to see it included, and the other two simply indicated a desire to know what the government's intentions were. There is thus every reason to believe that several of the potential investors would be interested in an arrangement that would at least have them responsible for the operation and maintenance of A and B, if not outright ownership. To prevent the Kosovo government from exploring these options with the consortia is to preempt the further work and analysis of the transaction adviser and potentially saddle Kosovo with devastating consequences.

-- There are, we believe, options that would allow the due diligence for A and B to be prepared for inclusion in the Request for Proposals (RFP) in a way that would not delay the overall RFP release. The provisional timetable presented in the current Draft Framework Document -- which calls for an RFP issue in April 2009, a bid due date of June 2009, and completion of negotiation in November 2009 -- is likely too ambitious at any rate, and the appropriate studies for inclusion of A and B could proceed quickly in time to be part of the overall package, particularly if the USG were willing in part or in whole to fund these efforts.

-- If operation and management of Kosovo A and B remain in the government's hands, there is an exponentially increasing risk of severe breakdown in one or more of the units, with the consequent risk of skyrocketing costs for imported power and repairs (if such were even possible). We should not forget that over a billion euro of donor money has already been poured into Kosovo's energy sector, simply to maintain existing operations. Donors would be unlikely to help foot the bill in the event of an emergency. The Bank's sanguine view of Kosovo A and B maintenance rests on overly optimistic assumptions and on a presumption that the U.S. will continue its costly technical assistance to Kosovo's energy sector for the duration of the interim period -- even while our best advice on commercializing the sector is undercut by Bank opposition.

-- A separate privatization or concessioning of Kosovo A and

B, outside the scope of the Kosovo C package, would render the old plants of far less interest to investors. It would almost inevitably result in a flawed and corrupt privatization process, with political cronies of the current government buying the two plants and providing energy to Kosovo at exorbitant rates -- knowing that once New Kosovo comes on line, they will cease to be competitive and will be forced out of business. Privatization of A and B delinked to New Kosovo will also vastly complicate the operation of the mining and energy sector, raising complex questions about control over mining assets and the transparency of interaction among multiple buyers and sellers of energy in such a small system. In 2008, the Embassy (with at least tacit support from the Bank) stopped Kosovo from pursuing such a plan to privatize A and B, for fear that this would negatively impact the New Kosovo project by raising the uncertainties involved and increasing corruption in the sector.

Comment and Recommendation

¶9. (C) A decision to jettison the idea of a packaged project -- or to put Kosovo A and B on a "separate track" from New Kosovo -- is premature. It also runs counter to the objectives of the Kosovo government, which have been clearly expressed (for the first time) in a letter sent by the Prime Minister to his Energy Minister and also provided to the IMF as an articulation of Kosovo's energy policy. The Kosovo government has an interest in developing an efficient, commercially-run energy sector that can meet short, medium and long-term needs and be a contributor to, rather than a burden on, the budget and economy. To exclude the possibility of pursuing this objective -- particularly when no real evidence exists that bidders will refuse to engage and when the consequences of leaving A and B out of the deal are potentially overwhelming -- does a serious disservice to Kosovo and substitutes the concerns of the World Bank for those of the transaction adviser and the Kosovo government.

¶10. (C) We believe strongly that the USG should back the process already underway that has the transaction adviser consulting with the government and the donors on their views; formulating answers to the bidders' questions including those related to the options for keeping A, B and New Kosovo together; and issuing a revised Framework Document that will more completely describe the project and provide the information the bidders need to determine their potential interest in A and B. With that feedback, there will be a solid basis for informed discussion of the scope of the project, i.e., whether to include or exclude A and B, as well as other terms.

¶11. (C) We would note with some concern as well that the Bank fails to take into consideration the dependence of the New Kosovo project on broader sector reform including not only A and B but privatization of the KEK distribution company, which USAID is supporting and which the Bank -- unsurprisingly -- opposes as another potential distraction from completion of the New Kosovo project. We are perplexed by their sanguine view that Kosovo's generation capacity and distribution system can be shored up through minor reforms and continued donor (U.S.) assistance, and we wonder how they would propose to have Kosovo bear the enormous costs of continued public investment in the sector -- unless perhaps through loans made either by the Bank or other lender. We also question the wisdom of continuing our energy assistance program if its basic tenets are consistently contravened by the Bank.

¶12. (C) We cannot speculate on what the Bank's position will be if we continue to support pursuing the possibility of a bundled package, but we would not exclude consideration by the Bank of pulling out of the project altogether. This would be highly unfortunate, not least because the Bank will ultimately be instrumental in providing risk guarantees for the project, one of the issues highlighted by bidders in the

recent round of discussions with the transaction adviser. No one wants such an outcome, but the threat of a Bank pullout should be weighed against the potentially catastrophic consequences, both economic and political, to Kosovo if budgetary outlays for KEK start to subsume all other expenditures. We would advise some thought be given to alternate risk guarantee mechanisms, though as a last resort after detailed discussion with the Bank.

¶13. (C) Time is ticking by. We have escaped the possibility of national elections in Kosovo for this year, but they remain highly likely for 2010 or 2011 at the latest, prompting many more months of delay and regression while campaigning and government formation take place. We lost months after the November 2007 elections trying to convince this government that adoption of the old government's energy policy on Kosovo C (New Kosovo) was a necessity. They are now not only convinced, but desperate to move ahead. Delaying more weeks for Bank concurrence on the way forward would be extremely damaging. We urge quick action from State and Treasury in conferring with the Bank and convincing them to reconsider their position. End Comment and Recommendation.

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